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PASS TREASURY FOR OASIA/ICB/VIMAL ATUKORALA
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SUBJECT: INFLATION AND INTERNATIONAL FINANCIAL CRISIS DAMPEN
AUSTRIA'S 2008/2009 ECONOMIC GROWTH OUTLOOK

REF: (A) VIENNA 0621; (B) VIENNA 0513

Summary

1. Austria's economy is starting to feel the impact of the international financial crisis and the high inflation resulting from continued raw materials and energy price hikes. Due to a still strong first quarter performance, Austria's two leading economic institutes recently upgraded GDP growth forecasts for 2008 to 2.2-2.3%. The Austrian economy continues to profit from strong exports, which are, however, weakening as are manufacturing and investments. Projections for 2009 are for growth of only 1.4-1.9%. Unemployment should remain at 4.2% in 2008 and rise only slightly to 4.3-4.4% in 2009. Economists are concerned about the high inflation rate. The 2008 budget deficit is forecast at 0.6% of GDP, but economists are less optimistic on the 2009 and 2010 budget outlook.
End Summary.

Slowdown in the Second Half of 2008

2. The Austrian Institute for Economic Research (WIFO) and the Institute for Advanced Studies (IHS) recently presented revised growth projections for 2008 and 2009. Both institutes upgraded their 2008 forecasts by 0.1-0.2 percentage point to 2.2% (IHS) and 2.3% (WIFO) because of an unexpectedly strong first quarter performance (annual growth rate of 3.3%). A recent Austrian National Bank (ANS) forecast also predicts 2.2%, a rate at which Austria's growth for the sixth consecutive year will have exceeded the expected Euro area growth by half a percentage point. However, available indicators point to a marked slowdown in the second half of the year, but with no danger of a recession. Exports continue to drive growth, but will expand at considerably lower rates than in past years due to the weak economies of major trading partners and the euro's appreciation. Investment spending is weakening and private consumption remains sluggish, reflecting a drop in real per capita after-tax net incomes in 2007. The savings rate will remain slightly above 10% of disposable income in both 2008 and 2009.

2009 - Less Than 2.0% Growth and Highly Uncertain

3. For 2009, the institutes again downgraded their forecasts by 0.3 percentage points, WIFO to 1.4% and IHS to 1.9%. The higher IHS projection reflects a more optimistic view of international developments and all demand aggregates. The ANB forecast is for 1.7%. This is a marked slowdown compared to the 3.4% growth in 2007

and the 2009 growth projections of 2.0-2.5% only six months ago. Both institutes conceded that the 2009 forecast contains major uncertainties, particularly the high volatility of raw material prices, exchange rates and financial markets. WIFO was unable to project the duration of the slowdown; the IHS saw chances for a new cycle to start in 2010.

Assumptions for Growth Forecasts

¶4. The institutes based their revised 2008/2009 forecasts on the following assumptions:

- U.S. economic growth of 1.4-1.5% in 2008 and 1.4-1.8% in 2009;
- Euro area growth of 1.7-1.8% in 2008 and 1.1-1.5% in 2009;
- EU-27 growth of 2.0% in 2008 and 1.4-1.7% in 2009;
- German growth of 2.0% in 2008 and 1.1-1.5% in 2009;
- oil prices of \$117-120 per barrel in 2008 and \$117-130 in 2009; and
- dollar/Euro exchange rates of 0.64-0.65 in 2008 and 0.63-0.69 in 2009.

Labor Market Turnaround in 2009

¶5. Austria's unemployment rate of 4.4% in 2007 was the sixth lowest within the EU-27, its employment rate of 71.4% the fourth highest. The outlook for economic growth of 2.2-2.3% in 2008 will bolster labor demand, dropping the unemployment rate to 4.2%. However, economists expect the slower 2009 growth will lead to a turnaround on the labor market, labor supply will again exceed demand and the unemployment rise to 4.3-4.4%.

Inflation - A Growing Concern, Wage Development Meager

¶6. Inflation remains a concern, particularly in view of a 3.7% rate in May 2008, the highest monthly rate in fifteen years. The institutes raised by 0.6 percentage point their projected annual average CPI increase to 3.2-3.5%, with food prices expected to go up 7% and energy prices 13%. The projected lower 2009 inflation of 2.3-2.7% reflects less dynamic economic growth and a stabilization of energy and raw materials prices. High inflation will also affect private households' purchasing power, explaining the sluggish private consumption growth. In 2008 and 2009, per capita pre-tax wages should increase 3.3% and 3.5%, respectively, but real after-tax incomes are forecast to decline 0.7% in 2008 and rise only 0.4% in 2009.

Stable Deficit in 2008, But Uncertain 2009/10 Outlook

¶7. The 2008 federal budget benefitted from continued high tax revenues during the first half of the year. However, additional revenues will be used up by the GoA's measures to combat rising inflation, i.e., the lowering of unemployment insurance contributions for low income groups and moving forward by two months to November 1, 2008 the annual pension increase (reftel A). WIFO expects the GoA to meet its public sector deficit goal of 0.6% of GDP in 2008. For 2009, no budget is available yet. However, because of the slowing economy, WIFO expects a public sector deficit of 0.8% for 2009, IHS of 0.4% - in any case worse than the figures the GoA submitted to Brussels in November 2007 in its updated 2007-2010 stability program, which projects a deficit of 0.2% of GDP in 2009 and a surplus of 0.4% in 2010. Economists are highly skeptical that the GoA will be able to render the projected surplus in 2010.

¶8. Statistical Annex

unless otherwise stated)

	WIFO project. 2008	IHS project. 2008	WIFO project. 2009	IHS project. 2009
Real terms:				
GDP	2.3	2.2	1.4	1.9
Manufacturing	3.8	n/a	2.2	n/a
Private consumption	1.1	1.4	1.2	1.5
Public consumption	2.5	3.0	1.0	0.0
Investment	2.4	2.5	1.0	2.1
Exports of goods	5.0	5.6	4.8	5.4
Imports of goods	4.3	6.1	4.3	5.0
Nominal Euro billion equivalents:				
GDP	286.5	285.5	297.4	296.6
Other indices:				
GDP deflator	2.7	2.5	2.3	2.0
Consumer prices	3.5	3.2	2.7	2.3
Unemployment rate	4.2	4.2	4.4	4.3
Current account (in percent of GDP)	2.8	n/a	2.6	n/a
Exchange rate for US\$ 1.00 in Euro	0.64	0.65	0.63	0.69

GIRARD-DICARLO